Boston College International and Comparative Law Review

Volume 1 | Issue 1 Article 8

1-1-1977

Foreign Currency Translation Methodology and its Impact on Multinational Financial Reporting

Joseph Brear

Foreign Currency Translation Methodology And Its Impact On Multinational Financial Reporting

Introduction

The current system of floating foreign exchange rates has complicated the financial management of multinational business.[1] A particularly troublesome area is the translation of foreign currency financial statements into dollars for domestic financial reporting purposes, and the related problem of the measurement and recognition of foreign exchange gains and losses. Existing accounting doctrine had been formulated during a period of relative exchange stability. Consequently, it offered only vague guidelines to account for the wide fluctuations that have recently occurred on international money markets. The financial reports of U.S. based multinationals during the last five years have been characterized by diverse approaches to the treatment of foreign exchange rate fluctuations. To achieve reporting uniformity, the Financial Accounting Standards Board (FASB) released Statement of Financial Accounting Standards No. 8 — accounting for the translation of foreign currency transactions and foreign currency financial statements (FASB #8).

This paper examines the impact of FASB #8 on U.S. based multinational financial reporting. This paper approaches the subject from the perspective that it is impossible to develop a translation system whose end product, accounts expressed in dollars, can answer all the questions that might legitimately

[1] A currency's exchange rates float when the rates at which it can be converted into other currencies are allowed to fluctuate over time in response to shifts in the supply of and demand for the currency on international money markets.

be raised about the impact of foreign exchange fluctuations on the multinational. The usefulness of any accounting procedure is limited by its underlying assumptions. Financial statements expressed in historic cost cannot answer questions about the impact of price level movements. The translation method outlined in FASB #8 represents one of several alternatives. As this paper will demonstrate, each alternative emphasizes the effect of a particular economic factor while ignoring the impact of other relevant economic factors. Each system was designed solely to answer a particular question and, consequently, ignore other equally relevant questions. Thus, the selection of one uniform method represents the resolution of the policy issue concerning which questions should be answered on the multinational's financial statements. This paper analyzes FASB #8 to determine what questions its translation method answers from the perspective of whether or not these questions are the critical questions to ask.

I. ASPECTS OF A FOREIGN EXCHANGE TRANSLATION SYSTEM

In financial accounting, consolidation is the process of adding a subsidiary's asset, liability and capital accounts to the corresponding accounts on the parent's financial statements.[2] Consolidation recognizes that, although a subsidiary may legally be a separate entity, in substance it is one component of a larger entity. Contemporary financial accounting attaches great value to the use of consolidated financial statements. In order to consolidate a subsidiary whose accounts are expressed in a foreign currency unit, the accounts must first be translated into dollars by using an exchange rate. The current floating exchange rate system introduces a new variable to the consolidation process, the selection of an appropriate exchange rate for translation.[3]

---

[2] Committee on Accounting Procedure, ACCOUNTING RESEARCH BULLETIN No. 51, Consolidated Financial Statements, ¶ I (1959).

[3] FINANCIAL ACCOUNTING STANDARDS, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 8. *Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements* ¶ 71-76 (1975) (hereinafter cited as Statement of Financial Accounting No. 8).

There are two variables to any translation system. The first involves the selection of the appropriate exchange rate. Basically, the choice is between historic rates prevailing at the time a transaction is consummated and current rates in effect at the time financial statements are issued.[4] The other variable is the determination of whether an account should be translated at historic or current rates. Most translation systems do not use a uniform exchange rate for all accounts.[5] Rather, an attempt is made to assign an account a rate that will preserve some attribute that is viewed as critical to accurate reporting. For example, many systems translate plant and equipment at historic rates in an attempt to preserve historic cost on the consolidated statements.[6]

A translation system consists of a matrix of accounts and their corresponding historic or current rates. The composition of this matrix will determine a foreign subsidiary's exposure to foreign exchange fluctuations. The difference between the assets and liabilities translated at current rates equals exposure.[7] These accounts are exposed because they are translated at current rates which may vary at each reporting date. The amount of exposure times the percentage change in exchange rates between reporting periods determines translation gain or loss. Thus, a multinational whose subsidiary is in a net asset position (an excess of assets translated at current rates over liabilities translated at current rates) will incur a translation gain if the foreign currency is revalued upward. If the foreign currency is devalued, a net asset position results in a translation loss. The opposite relationships exist for a subsidiary in a net liability position.[8] *See exhibit I in Appendix.*

---

[4] Aliber & Stickney, *Accounting Measures of Foreign Exchange Exposure: The Long and Short of It*, 50 THE ACCOUNTING REV. 44-45 (1975).

[5] STATEMENT OF FINANCIAL ACCOUNTING No. 8, ¶ 121.

[6] The temporal, monetary-nonmonetary and current-noncurrent methods translate plant and equipment at historic rates. Id.

[7] Id. ¶ 243.

[8] See Exhibit I in the Appendix for an illustration of the difficulty of devising a translation system that yields both a realistic measurement of translation gain or loss and accurate measurement of account balances on the balance sheet. Exhibit

A rational translation system should yield a translation gain or loss that is a measure of the economic consequences of exchange fluctuations. The goal should be a figure that will be meaningful to the users of financial statements. Exhibit I,[9] illustrates that translation gain or loss is a function of which accounts are translated at current rates. As noted earlier, the decision to translate a particular account at current rates is based on an attempt to preserve some critical account attribute such as historical cost or current market value. Preserving these attributes may or may not have any relation to a realistic appraisal of economic gains or losses from foreign exchange fluctuations. Attribute preservation is necessary for the proper presentation of relationships between accounts on the balance sheet.[10] If the translation system focuses completely on attribute preservation, however, the amount of translation gain or loss may be distorted and bear no relation to economic substance.[11]

In exhibit I,[12] the devaluation reduces the dollar value of the subsidiary's future income stream, since future sales will be translated into dollars at the new lower rate. The subsidiary's assets will earn less in dollar terms. This decreased income potential might be a better measure of translation loss than the decreased value of net current assets employed by the current/

I demonstrates that under the current-noncurrent method a 50% devaluation of a foreign currency relative to the dollar yields only a 25% decline in the foreign, subsidiary's translated net worth.

[9] See Appendix infra.

[10] STATEMENT OF FINANCIAL ACCOUNTING No. 8, ¶ 122.

[11] Exhibit I in the Appendix infra illustrates this tension. Exhibit I depicts the current-noncurrent method in a devaluation situation. This system is designed to portray the amount of dollars that would be realized if each current asset account were liquidated and the proceeds converted into dollars on the balance sheet date. The attribute this method preserves is the present value of current assets. While present value is a useful attribute to portray, Exhibit I illustrates that focusing on only one relationship results in a translation loss that is a smaller percentage of net worth than the percentage change in the exchange rate. Thus, in Exhibit I, if the foreign subsidiary were subsequently liquidated, additional exchange loss would have to be recognized because the devaluation reduced the value of all assets not just current assets.

[12] See Appendix infra.

noncurrent method. It is submitted that resolution of the question of which approach is better involves a policy determination of which approach strikes the best balance between utility and economic reality. The balance of this paper evaluates FASB #8 in terms of the economic factors its system focuses on and contrasts them with the economic relationships portrayed by alternative systems, in an attempt to assess FASB #8's impact on the quality and conduct of multinational financial reporting.

II. FASB #8 — THE TEMPORAL METHOD OF TRANSLATION

Prior to FASB #8, there were two generally acceptable methods of translating foreign currency financial statements: the current/non-current method and the monetary/non-monetary method.[13] The second method translates accounts that represent amounts of foreign currency, cash, and accounts that represent rights to or obligations to pay foreign currency, receivable and payable, at current rates. All other accounts are non-monetary. They are translated at historic rates. This system focuses on the parent's command over foreign currency. An increased or decreased command over foreign currency at the balance sheet date is the monetary/non-monetary system's measure of translation gain or loss. Prior to FASB #8, most multinationals employed hybrid systems, combining elements of both methods.[14] Translation gain or loss was not recognized on a uniform basis. Some firms reduced the amounts of translation gain or loss by estimates of future exchange rate fluctuations. Other firms buried translation losses in reserve accounts. FASB #8 ended this diversity by providing a single translation system to be used by all reporting entities.

According to FASB #8 paragraph 11, cash and accounts receivable or payable that are denominated in a foreign currency

[13] For a description of the current-noncurrent method see Exhibit I in the Appendix infra.

[14] Pakkala, *Foreign Exchange Accounting of Multinational Corporations*, FINANCIAL ANALYSTS J., March-April, 1975, 32, 33.

are translated into dollars at the current exchange rate.[15] For assets and liabilities other than those described in paragraph 11, paragraph 12 specifies that the particular measurement basis shall determine the translation rate.[16] In financial accounting, an asset or liabilities measurement base is a money price in effect at a point in time. Thus, the rule requires that assets carried at historic cost be translated at the historic rate in effect when they were first acquired. Marketable securities carried at current market price would be translated at the current rate because they are measured at a current money price. Paragraph 13 requires that revenue and expense transactions be translated in a manner that produces approximately the same dollar amounts that would have resulted had the underlying transaction been translated into dollars on the dates they occurred.[17] Paragraph 13 sanctions the use of average rates for convenience in translating revenue and expense items. Paragraph 17 provides that translation gains and losses shall be included in net income for the period in which the rate changes.[18]

A. *Assumptions Underlying The Temporal Method*

FASB #8 adopts the temporal translation method; a system predicated upon two assumptions. First, foreign exchange translation is viewed as a neutral measurement conversion process.[19] Since translation is neutral, it is possible to preserve the underlying attributes of foreign currency accounts. Therefore, a rational translation system should look to account attributes for a key to a translation mechanism. Conventional accounting ascribes the following attributes to assets and liabilities: money is measured at the quantity owned at the balance

---

[15] STATEMENT OF FINANCIAL ACCOUNTING No. 8, ¶ II.

[16] Id., ¶ 12.

[17] Id., ¶ 13.

[18] Id., ¶ 17. For an example of the application of FASB #8 to a foreign subsidiary's balance sheet during a devaluation period see Appendix Exhibit II.

[19] Lorenson, *The Temporal Principle of Translation*, THE J. OF ACCOUNTANCY, August 1972, 48, 49.

sheet date, receivables and payables stated at amounts promised are measured at money amounts that pertain to the balance sheet date, and all other assets and liabilities are measured at money prices in effect at the balance sheet date (market value) or when the assets or liabilities were acquired or otherwise recorded in the accounting records (historic cost).[20] The last category's attribute is a money price measured at a point in time. The temporal character of these prices correspond with historic and current exchange rates. Therefore, it seems reasonable to match the time that the money price is determined with the exchange rate in effect at that point in time. This should yield translated accounts whose temporal character is preserved. Thus, FASB #8 maintains that fixed assets' historic cost can be preserved by translating at the exchange rate in effect when the assets were acquired. The remaining asset and liability categories require a modified approach. The second assumption underlying the temporal method is that the attribute of foreign money and foreign money receivables in foreign currency financial statements are the quantities of foreign currency owned or promised. The quantity of an item can only be measured in a unit of measure defined in terms of that unit. Thus, another attribute must be measured. The temporal method assumes that the attribute of foreign currency of most interest from the perspective of U.S. dollar financial statements is its command over U.S. dollars.[21] This command is best measured at exchange rates in effect at balance sheet dates. In making this assumption, FASB #8 defines exposure as generally net monetary position.[22] Exposure in turn determines translation gains and losses. FASB #8, however, does not approach the gains and losses issue from the perspective of what is the best measure of exchange rate fluctuation impact. Rather, translation gains and losses are still a function of balance sheet valuation and attribute preservation.

---

[20] Id. at 50.

[21] Id. at 51.

[22] Id. at 52-53.

Exhibit II[23] illustrates the consequences of FASB #8's balance sheet emphasis. The treatment of income statements items is similar to the treatment of balance sheet items. Revenue and expense items are translated at the exchange rate in effect when the transaction is reported for accounting purposes. This is the temporal approach applied to the income statement. A sale on 5/1/7X is translated at the 5/1/7X exchange rate. Depreciation is measured by the asset's historic cost. Consequently, FASB #8 translates depreciation at the rate in effect when the asset was acquired. In Exhibit II translating income yields a net loss, however, 13FC of income is available for distribution to the parent as dividends.

FASB #8 requires that translation gains and losses be recognized in income in the period in which they occur to avoid artificial smoothing of net income by deferral.[24] This immediate recognition is in part a reaction to the diverse treatments of translation gains and losses that existed prior to FASB #8 that was characterized by manipulation and concealment.[25] It also reflects the view, that exchange rate fluctuations do have a real impact on the economics of multinational business that should be portrayed in the financial statements.

Two assumptions were made in the formulation of FASB #8's translation system. First, foreign currency translation is a neutral measurement conversion process. Second, exposure and related translation gains and losses is a function of net monetary position. This section evaluates the usefulness of the financial information provided by a translation system based on these assumptions by comparing FASB #8's system with an income oriented translation system.

An income oriented approach to foreign exchange translation focuses on the effects foreign exchange fluctuations have on a foreign subsidiary's future income stream.[26] The essential dif-

---

[23] See Appendix infra.

[24] STATEMENT OF FINANCIAL ACCOUNTING No. 8, ¶ 196-99.

[25] Id., ¶ 194.

[26] Seidler, *An Income Approach to the Translation of Foreign Currency Financial Statements*, THE CPA J., January 1972, 26, 31.

ference between an income oriented approach and FASB #8 is that an income oriented approach views translation as an active process that factors into the accounts the results of past economic activity that has accounting relevance. This concept is based on the notion that a change in exchange rates between 1/1/7X and 12/31/7X represents a change in relationships between two economies sufficiently effecting a business entity to warrant disclosure in the financial statements. Therefore, the change requires accounting recognition. Thus, on 1/1/7X, economists believe that the FC for a variety of reasons, some political and some economic, is overvalued relative to the dollar. During the year, international money markets confirm this view. There is wide agreement that the exchange rate is now more reasonable. A devalued FC reduces the dollar value of a foreign subsidiary's future FC income stream. The income oriented translation system is designed to measure this reduced value.

Like FASB #8, the income oriented system is concerned with asset valuation and notions of historic cost. An asset's historic cost is a measure of the discounted present value of the future income streams generated by the asset. The asset's price is set by open market forces, however, in real terms assets are worth only as much as the discounted income streams they generate for a particular firm. Each firm makes its own calculations about future income streams and acceptable rates of return on capital. If the purchase decision is rational, no asset would be purchased whose discounted present value is less than its purchase price. Otherwise, the firm would not be able to earn its desired rate of return on capital. The fact that the asset is acquired in an open market transaction imparts great evidential value to management's estimation of discounted present value. The asset's open market price is thought to be the most accurate expression of value for financial accounting. This measure is preserved by constructing financial statements in terms of historic cost. Yet, if the purchase decision is rational, the purchase price is also an expression of management's estimate of the asset's discounted present value. Thus,

asset valuation is essentially concerned with expressing an asset's earning power. Historic cost is a measure of asset earning potential set in an open market transaction.[27] In a foreign country, the decision variables, expected income stream, acceptable rate of return and market supply and demand, are all affected by local economic conditions. Thus, the asset's purchase price is an expression of historic foreign currency cost. FASB #8 seeks to preserve this valuation by translating assets carried at historic costs at historic rates. Although the FC value of the asset's discounted future income stream may remain unchanged, economic interaction between the U.S.'s and the foreign country's economies may result in a devalued FC. The devalued FC results in a reduced dollar value for future FC income streams. By translating the asset at higher historic rates, FASB #8 overvalues the present dollar value of the asset's future FC income stream. An income oriented approach would translate the asset at lower current rates, thus, yielding a dollar value that more accurately portrays the asset's present dollar value.

Foreign exchange rates change over time because of the interplay of a variety of political and economic factors. While exchange rate fluctuations represent the product of the interaction of two economics, the focus of change generating activity in the short run is likely to occur in only one economy. The location of the economic forces that produce exchange rate changes is accounting relevant information. Thus, management and investors would be interested in whether the exchange rate moved because of factors within the foreign country or economic factors within the U.S. By translating fixed assets at historic cost, FASB #8 implicitly assumes that all currencies move relative to a stable dollar. For example, X's manufacturing efficiency increases relative to the U.S.'s because X keeps wages low and working hours long. This increased efficiency attracts outside capital. X's foreign currency unit, the FC, is sought in order to invest in X and buy X's cheaper products. The value of the

[27] Fantl, *The FASB And the Currency Translation Bungle,* THE WOMEN CPA, October, 1975, 5, 30.

FC relative to the dollar increases on world money markets. Under FASB #8, plant and equipment of the U.S. based subsidiary operating in X is translated at the lower historic rate.[28] The FC's revaluation has, however, increased the dollar value of the income stream generated by the plant and equipment. FASB #8 overlooks this increased dollar value. It implicitly assumes that the dollar is an unchanging benchmark of value.[29]

B. *The Utility of An Income Oriented Approach*

The use of the income oriented approach is not replacement value accounting. Rather, it is an attempt to preserve an asset's historic cost in terms of the foreign currency that was used to purchase the asset. It preserves the measure of foreign currency historic cost of accounts translated into dollars by selecting an exchange rate that will factor in the present dollar value of future FC income. Exhibit III assumed the FC devaluation was not accompanied by a price increase in the foreign country. This will not always be the case. If devaluation were associated with a domestic price rise, the income oriented system would translate fixed assets at historic rates. An increase in domestic prices would preserve the dollar value of future FC income. Thus, in the situation of devaluation and continued inflation, the FASB #8 yields economically more correct results. This situation is only one out of a matrix of possibilities. Thus, if the income oriented approach is assumed to be superior, FASB #8 distorts financial reporting of foreign subsidiaries located in West Germany because of the marks revaluation upward relative to the dollar.

An income oriented approach produces translated statements that portray a useful measure of the impact of exchange rate fluctuations on the economic condition of foreign based sub-

[28] STATEMENT OF FINANCIAL ACCOUNTING No. 8, ¶ 12.

[29] See Exhibit III in the Appendix for a comparison of the income oriented approach with FASB #8's method. Exhibit III illustrates that in a devaluation situation FASB #8 yields a translation gain in the year of devaluation, but reports the gain at the price of undervaluing the actual dollar value of subsequent years foreign currency earnings. The income oriented approach accurately reports the actual dollar value of foreign currency earnings for all years.

sidiaries.[30] Investors invest in going concerns that generate income over time. Management's goal is to prudently invest those funds in projects generating acceptable rates of return over time. Careless management invests in a foreign country X characterized by inefficient industry and high levels of inflation. X's currency devalues relative to the dollar. Because most firms have net liability positions under FASB #8, management is rewarded with a translation gain. The dollar value of future FC income, however, is reduced. Conversely, prudent management, invests in foreign country Y because they believe Y is more dynamic than X. Prudent management is correct. Y's dynamic economy results in a movement of Y's FC upward relative to the dollar. Because of its net liability position under FASB #8, prudent management is penalized by a translation loss.

In many situations, FASB #8 appears to yield financial information with only slight value. FASB #8 distorts future income measurement because it places undue emphasis on balance sheet valuation. Balance sheet valuation is important; however, FASB #8 ignores the going concern principle. Balance sheets, by measuring value at a point in time, should be an expression of an entity's future revenue potential. FASB #8's shortcomings stem from viewing translation as a neutral process. The use of exchange rates implicitly acknowledges that some relationship exists between two economic systems. Employing a matrix of current and historic rates factors into the financial statements the consequences of exchange rate fluctuations. Thus, translation is an active process. A more useful translation system may be constructed on this assumption: foreign currency historic cost is an expression of the present value of future foreign currency income; therefore, an asset's translated dollar value should be an expression of the present dollar value of future foreign currency income. This approach would appear to yield more useful financial information than that provided by FASB #8.

[30] Connor, *Accounting For the Upward Float In Foreign Currencies*, THE J. OF ACCOUNTANCY, June, 1972, 39, 43.

FASB #8's IMPACT ON MULTINATIONAL FINANCIAL REPORTING

FASB #8's requirement of immediate recognition of translation gains and losses has generated the greatest controversy among multinationals.[31] Multinationals appear to be very concerned with reporting a smooth progression of increasing profit from reporting period to reporting period. Multinationals are also very interested in maintaining this pattern in their quarterly reports. FASB #8 paragraph 17 requires that translation gains and losses for the quarter reported on be included in quarterly profit and loss.[32] Exchange rates may fluctuate widely within a year. Thus, quarterly reports may show wide shifts in profit or loss whose movement and magnitude may be difficult to predict. For example, on 1/1/7X, 1FC equals $1. On 3/31/7X, .9FC equals $1. On 6/30/7X, .8FC = $1. On 9/30/7X .78FC = $1.00. By 12/31/7X, a crisis of confidence in the FC has driven the rate back to 1FC equals $1. Multinational X has a net liability position. It would report translation losses for the first three quarters. For the year, it would report no translation gain or loss. The shifts in profit produced by exchange rate fluctuations would be magnified in quarterly reports since there is no guarantee exchange rates will follow a seasonal pattern.

Sophisticated analysts should be able to subtract the impact of exchange rate changes from actual operating results. Confusion will be a function of how much emphasis is placed on the bottom line. Some multinationals apparently believe that the bottom line figure of profit or loss is critical. TRW after applying FASB #8 had a $30 million net liability position in West Germany.[33] Each time the mark appreciated 1% relative

---

[31] See Exhibit IV in the Appendix for a comparison of FASB #8 with the two translation methods available to multinationals prior to FASB #8. Exhibit IV illustrates that if inventory is carried at cost, FASB #8 and the monetary-nonmonetary system yield the same results.

[32] STATEMENT OF FINANCIAL ACCOUNTING No. 8, ¶ 17.

[33] Revzin, *New Accounting Rule Makes Multinationals Alter Their Strategies*, THE WALL STREET JOURNAL, December 8, 1976, at 34, col. I. (Hereinafter cited as *New Accounting Rule.*)

to the dollar, TRW was faced with a $300,000 translation loss. To avoid future translation loss, TRW converted its mark debt into dollar debt.[34] This conversion from mark debt to dollar debt probably resulted in a realized translation loss. Over the last five years, the mark's general trend has been to rise in value relative to the dollar. Some portion of TRW's long term mark debt must have been incurred when the dollar was worth more relative to the mark. As the mark rises in value proportionately more dollars are required to satisfy a given amount of mark debt. Therefore, it must have taken more depreciated dollars to convert some of the mark debt than the original dollar value of the debt. This is a realized translation loss. TRW was willing to realize actual translation loss to avoid future paper translation losses on its financial statements.

Another approach to avoiding translation loss is to offset losses with gains. Sperry Rand and ITT appear to be following this approach by increasing their net liability exposure in weak currency countries. Devaluations yield net translation gains for subsidiaries with net liability exposure.[35] Sperry Rand and ITT are reducing working capital balances through special dividends and tight budgetary controls to increase net liability exposure and, therefore, the amount of translation gain.[36] Thus, rather than realize their translation gains and repatriate the proceeds or invest the funds in increased operations, some multinationals appear to be willing to cut working capital to a minimum in order to increase unrealized but recognized translation gain.

There is merit to a policy of immediate recognition of translation gains and losses. Management and investor decision making is concerned with allocating and reallocating resources in a search for optimal returns. Such decisions, require a current, comparable view of available assets. Therefore, some immediate recognition of the impact of currency exchange rate change is desirable. Deferral does result in artificial smooth-

[34] Id.

[35] See Exhibit II in the Appendix infra.

[36] *New Accounting Rule*, supra note 32, at 34, col. 3.

ing. Variations in profit and loss patterns is relevant financial information. The root of the reporting problem posed by FASB #8's treatment of exchange gains and losses does not involve recognition. FASB #8 may not be using the best available measure of translation gains and losses. As noted earlier, FASB #8 arrives at a measure of translation gains and losses indirectly. FASB #8 implicitly defines exposure as net monetary position. This decision, however, was only a consequence of determining what would be the most interesting attribute of foreign cash and foreign currency receivables and payables to portray on U.S. financial statements. FASB #8 did not address the question of what is the optimum measure of exchange rate fluctuation that can be depicted within the limits of conventional financial accounting. Having addressed the question indirectly, FASB #8 then takes a strong stand on recognition.

While the multinational's command over dollars at a point in time is of some interest, it may be a misleading figure. Practical needs to reinvest foreign currency cash flows would generally prevent a parent from immediately realizing in full the benefits of an exchange rate change. Further, exchange rate fluctuations in subsequent periods could offset previous period gains. The approach taken by Sperry Rand and ITT suggest that FASB #8 may effect multinational conduct in an uneconomic fashion. Both firms apparently were willing to reduce working capital to a minimum in order to generate additional paper translation gains rather than realize those gains. An accounting system should only measure financial activity and not bias that activity's direction and magnitude.

CONCLUSION

FASB #8 does provide reporting uniformity for the results of foreign operations of U.S. based multinationals. Unfortunately, it does not appear to have improved the quality of the reporting. It is submitted that FASB #8 distorts translated asset values in many reporting situations. These distortions result in distorted future income measurement. Also, it may en-

courage uneconomic conduct on the part of multinationals to generate paper translation losses. These shortcomings are the consequences of attempting to devise a translation system by reasoning from U.S. generally accepted accounting principles. Apparently, FASB #8's framers failed to realize that translation is not comparable to the consolidation of parents and domestic subsidiaries. What is needed is more research on the real impact of exchange rate fluctuation on the economics of multinational business. Then, having defined what activity needs to be measured, a translation system could be constructed to account for this activity.

JOSEPH BREAR

APPENDIX

Exhibit I

Exhibit I portrays the impact of a devaluation on a foreign subsidiary's exposure under the current/non-current translation method. This method was one alternative available to U.S. multinationals prior to FASB #8. In this system current assets and liabilities are translated at rates prevailing at the balance sheet date. All other accounts are translated at historic rates. On 1/1/7X 1FC equaled $1. On 12/31/7X 2FC equaled $1. The translation loss is $12.5. This system measures the consequences of currency fluctuations in terms of its impact on current assets and current liabilities. The subsidiary's net asset exposure is 25FC. The FC has declined 50% in value relative to the dollar between reporting dates. On 1/1/7X, 25FC of assets was worth $25. On 12/31/7X, the same amount of assets, if liquidated, commands only $12.5. The decrease in dollar value of exposed assets is a translation loss of $12.5. Viewed differently, 50FC of owners equity worth $50 on 1/1/7X is now worth only $37.5. Although the FC devalued by 50%, and 50% of $50 worth of owners equity is $25, the translation loss is only $12.5 because the current/non-current system defines exposure as the difference between current assets and current liabilities.

Exhibit I

FC has devalued from 1FC = $1 to 2FC = $1.

Cash	10FC	×.5	$ 5
Accts. Rec.	18	×.5	9
Inv.	22	×.5	11
Plant and Equip.[1]	50	×1.0	50
	100FC		$75
Accts. Pay.	25	×.5	12.5
Long Term Liabilities[1]	25	×1.0	25
Owners Equity	50	—	37.5
	100FC		$75

[1] Plant and Equipment was acquired and Long Term Liabilities incurred when 1FC = $1.

Exhibit II

Exhibit II is an application of FASB #8 to a foreign subsidiary's balance sheet and income statement during a devaluation period. On 1/1/7X, 1FC equaled $1. On 12/31/7X, 2FC equaled $1. Although the FC declined in value, a translation gain of $11 is reported. Like the monetary/non-monetary system, FASB #8 translates monetary assets and monetary liabilities at current rates. Thus, exposure to foreign exchange fluctuation is a function of net monetary position. Exhibit II illustrates a firm with a net monetary liability position of 22FC. The FC's 50% decline in value yields a translation gain because less dollars satisfy the subsidiary's FC debt on 12/31/7X than were needed to satisfy the debt on 1/1/7X. Under FASB #8, the focus of translation gains and losses is on net monetary position. Translation of the income statement yields no separate translation gain or loss. The income statement, however, does reflect the assumptions that are made about balance sheet translation procedure. A $3 net loss is reported on the translated income statement. A loss is reported because depreciation is translated at an exchange rate higher than the average exchange rate used to translate revenue. Depreciation must be translated at the rates that were in effect when the assets were acquired.

Exhibit II

The impact of FASB #8's translation method on a foreign currency devaluation.

Historic rate	1FC = $1	on 1/1/7X
Current rate	2FC = $1	on 12/31/7X
Average rate	1.5FC = $1	

Balance Sheet

Cash	10FC	× .5	$ 5
Accts. Rec.	18	× .5	9
Inv. (cost)[1]	22	×1.0	22
Plant and Equip.[1]	50	×1.0	50
	100FC		$86
Accts. Pay.	25	× .5	12.5
Long Term Liabilities	25	× .5	12.5
Owners Equity	50	—	61[2]
	100FC		$86

[1] Inventory and plant and equipment were acquired when the exchange rate was 1FC = $1.

[2] Translation gain is the sum of cash and accts. receivable (net monetary assets) minus accts. payable and long term liabilities (net monetary liabilities) × the percentage change in FC's relative to the dollar, 50%.

$$(10FC + 18FC) - (25FC + 25FC) = 22FC \times 50\% = \$11$$

Income Statement

Sales[1]	120FC	×.667	80
Cost of Goods Sold	80[2]	×.667	60
Depreciation	15[2]	×1.0	15
Gross Profit	25		5
General and Selling Ex.	12	×.667	8
Net Profit before tax or (loss)	13FC		3

[1] Assumes all revenue and expenses incurred uniformly throughout the period, therefore, average rates are used.

[2] Depreciation is translated at its historic cost per paragraph 13.

FASB #8's income impact in varying situations is illustrated in the following table.

Situation	Effect (Per FASB #8)
Foreign subsidiary's currency weakens in relation to home country currency (loss potential is high):	
1. Subsidiary has an excess of monetary liabilities over monetary assets.	Gain on Foreign Exchange
2. Subsidiary has an excess of monetary assets over monetary liabilities.	Loss on Foreign Exchange
Foreign subsidiary's currency strengthens in relation to home country currency (potential gain situation):	
3. Subsidiary has an excess of monetary liabilities over monetary assets.	Loss on Foreign Exchange
4. Subsidiary has an excess of monetary assets over monetary liabilities.	Gain on Foreign Exchange

Exhibit III

An extended example illustrates the distortions FASB #8 can produce. Exhibit III depicts the relationship between a fixed asset and the revenue it generates when the FC is devalued. The asset cost 9000FC and has a three year life. Depreciation is straight line. 9000FC was borrowed locally to purchase the asset. The loan is paid ratably over three years. On 1/1/7X, IFC equals $1. On 12/31/7X, 2FC equals $1. The devaluation occurs on money markets ratably throughout Year I. The devaluation stems in large part from inflation in X in years prior to year I. Conditions stabilize in X during Year I. Consequently, the asset's gross earning stream remained a constant 15000FC.

The impact of different translation methods on profit and loss in the year of devaluation and subsequent years.

Income oriented translation method

	YEAR I		YEAR II		YEAR III	
	FC	$	FC	$	FC	$
Sale[1]	15,000	10,000	15,000	7,500	15,000	7,500
Depr.[2]	3,000	2,000	3,000	1,500	3,000	1,500
Translation Gain or (Loss)	—	3	—	—	—	—
	12,000	8,000	12,000	6,000	12,000	6,000

Total three year profit = $20,000.

[1] Sales were made uniformly in Year I. The weighted value of $1 in terms of FC's during year I was $1 = 1.5FC. Thus, year I sales translated are 15,000 FC ÷ 1.5 = $10,000. Years II and III were translated at 15,000FC ÷ 2FC = $1.

[2] Like sales, Year I depreciation is translated at the weighted dollar value of the FC, 1.5. 3,000FC ÷ 1.5 = $2,000. In years II and III, 2FC = $1. Therefore, 3,000FC ÷ 2 = $1,500.

[3] No translation loss is recognized. The loss in year I is recognized as realized in the reduced dollar value of the subsequent years FC income.

FASB #8 translation method

	YEAR I		YEAR II		YEAR III	
	FC	$	FC	$	FC	$
Sales[4]	15,000	10,000	15,000	7,500	15,000	7,500
Depre.[5]	3,000	3,000	3,000	3,000	3,000	3,000
Translation Gain or (Loss)	—	4,000[6]	—	—	—	—
	12,000	11,000	12,000	4,500	12,000	4,500

Total three year profit = $20,000.

Exhibit III's most striking feature is that total translated income under both methods is the same. This perfect equality will not always be the case. It exists in Exhibit III because fixed assets equaled long term liabilities. This qualification should not obscure the fact that differences between translation methods are largely resolved into timing questions. FASB #8 yields higher translated income in year I because it defines exposure as net monetary position. Because of the magnitude of long term debt, most firms will have net liability exposure. Consequently, devaluation results in a translation gain. Exhibit III depicts such a situation. High year I profits, however, are followed by sharply reduced translated profit for years II

[4] Translated sales are the same as in the income approach.

[5] Depreciation is translated at the historic rate of IFC = $1.

[6] There are two components to this figure. At the end of year I, 6,000FC of debt used to purchase the asset is outstanding. Because of the devaluation, only $3,000 is needed to discharge the debt. At the beginning of year I, $6,000 was required to satisfy the debt. The difference of $3,000 is treated as a realized translation gain by FASB #8. The remaining $1,000 represents the actual foreign exchange gain that could have been realized through consumated market transactions in Year I. 3,000FC of debt was paid ratably throughout Year I. At each payment date progressively, less dollars were needed to discharge an obligation originally valued at $3,000. The gain is $3,000, the value of one year's payments at the beginning of year I minus 3,000 ÷ 1.5 the FC's weighted value in Year I. Actually, a multinational may not use dollars to purchase FC's to satisfy its FC obligation in order to realize all possible exchange gains. I have assumed this because FASB #8 uses monetary exposure as an accounting measure of the economic consequences of exchange rate fluctuations.

and III. This is a consequence of matching depreciation translated at higher historic rates with revenue translated at devalued current rates. Consequently, FASB #8's translated income bears no relationship to the dollar value of FC profits available for distribution as dividends. Finally, a balance sheet drawn at year I's end would value the asset at $6,000, its old historic rate; however, devaluation has sharply reduced the dollar value of the asset's future income stream. The income oriented approach produces no translation gain or loss in Year I. The devaluation impact is measured by a reduced asset value of 3,000 on the balance sheet. Translated income corresponds to the dollar value of each year's FC income. The variation between profit over three years is a function of the decreased FC value. Thus, 12,000FC worth an average of $8,000 during year I is correctly portrayed as worth $6,000 in years II and III. Translated net income portrays the impact of devaluation on net income's dollar value.

Exhibit IV

Exhibit IV compares FASB #8 with the two translation alternatives available to multinationals prior to FASB #8. Exhibit IV illustrates that, if inventory is carried at cost, FASB #8 and the monetary/non-monetary system yield the same results. Generally, both systems will have the same measure of exposure. Thus, except for FASB #8's provision requiring immediate recognition of exchange gains and losses, FASB #8 will not radically improve or alter the financial reporting of multinationals who previously used the monetary/non-monetary system. By providing a uniform translation system, however, FASB #8 eliminates a multinational's ability to select a translation system that always produces a translation gain no matter what direction the currency fluctuation takes. Exhibit IV indicates that prior to FASB #8, a multinational could select between a system yielding either a net asset or net liability position depending upon whether it faced a revaluation or devaluation situation. FASB #8 at least achieves some uniformity in reporting and reduces the potential for manipulation.

Exhibit IV

		Current/ Non-Current		Monetary/ Non-Monetary		FASB #8	
		H	C	H	C	H	C
Cash	10		X		X		X
Accounts Receivable	18		X		X		X
Inventory (Cost)	22		X	X		X	
Plant & Equipment	50	X		X		X	
Accounts Payable	25		X		X		X
Long Term Liabilities	25	X			X		X
Equity	50	—		—		—	
Exposure			25		(22)		(22)
		Loss on devaluation Gain on revaluation		Gain on devaluation Loss on revaluation		Gain on devaluation Loss on revaluation	